
April 1996

TAX
ADMINISTRATION

Alternative Strategies
to Obtain Compliance
Data



General Government Division

B-266028

April 26, 1996

The Honorable Margaret Milner Richardson
Commissioner of Internal Revenue

Dear Ms. Richardson:

On October 23, 1995, the Internal Revenue Service (IRS) decided to postpone the 1994 Taxpayer Compliance Measurement Program (TCMP) indefinitely because of budget concerns. Also, there was considerable pressure from Congress, taxpayer groups, paid preparers, and others to cancel TCMP because of its cost and burden on taxpayers. In light of its postponement, we initiated this assignment to determine the potential effects on IRS' compliance programs of postponing the 1994 TCMP and to identify some potential short- and long-term alternatives to the planned TCMP for collecting this data.

Background

For over 30 years, TCMP has been IRS' primary program for gathering comprehensive and reliable taxpayer compliance data. It has been IRS' only program for making statistically reliable estimates of compliance nationwide. It has also been used to identify areas where tax law needs to be changed to improve voluntary compliance and to estimate the tax gap and its components.¹ TCMP data are also used outside IRS, including by Congress to make revenue estimates for new legislation and by the Department of Commerce's Bureau of Economic Analysis to adjust national income accounts such as the gross domestic product.

The 1994 TCMP survey, which was to consist of over 150,000 income tax returns, was to be the most comprehensive TCMP effort ever undertaken. By auditing the tax returns of individuals (Form 1040), small corporations with \$10 million or less in assets (Form 1120), Partnerships (Form 1065), and S corporations² (Form 1120S), IRS planned to obtain comprehensive compliance data. Most sample results were to be sufficiently precise to be reliable at the national level as well as at smaller geographic areas across the country. The 1994 TCMP was designed to fulfill the information needs for several compliance areas expected to be important to IRS' functions over the next decade. The more important uses were to include development of audit selection formulas, validation of IRS' revised

¹The tax gap is the difference between the amount of taxes owed and the amount voluntarily paid in a year.

²An S corporation is taxed similar to a partnership. A qualifying corporation may choose to be generally exempt from federal income tax. Its shareholders will then include in their income their share of the corporation's separately stated items of income, deductions, losses, and credits.

approach to categorizing returns for audit, and development of new approaches to researching compliance across specific geographic areas. Each of these uses is discussed in more detail below.

Since 1969, IRS has used TCMP data to update its Discriminant Function (DIF) formulas, which are mathematical formulas used to select tax returns with the greatest probability of change for audit. The current formulas for individuals are based on 1988 tax returns, IRS' most recent individual TCMP audits. Formulas for small corporations are based on returns that were processed in 1987. IRS does not use DIF scores for partnerships and S corporations because of the age of the underlying TCMP audits.

TCMP data were also to be used to test new compliance strategies. IRS planned to change the way it categorized returns for audit by adopting the market segment approach. Market segments represent groups of taxpayers with similar characteristics, such as those in manufacturing. IRS assumes that because these taxpayers have similar external characteristics, their tax compliance behavior will exhibit similar attributes.

Finally, the 1994 TCMP was to provide compliance research data. IRS recently reorganized its compliance research function, establishing a National Office of Research and Analysis (NORA) and 31 District Office of Research and Analysis (DORA) sites. The 1994 TCMP was to be large enough to provide reliable compliance data for field and National Research Offices. IRS' researchers planned to use TCMP data to identify national and geographically specific areas of noncompliance and, by focusing on key compliance issues, develop programs to improve voluntary compliance. It is through these research efforts that IRS planned to improve overall voluntary compliance.

Noncompliance represents a major source of lost revenue for the nation. IRS' most recent tax-gap estimates indicate that over \$127 billion was lost to noncompliance in 1992. In an attempt to reduce this lost revenue, IRS established an objective of collecting at least 90 percent of the taxes owed through voluntary compliance and enforcement measures by the year 2001. However, this overall compliance rate has remained at about 87 percent since 1973. The 1994 TCMP was intended to provide data from which other programs could be developed to improve this rate and increase revenue.

This nation's tax system is based on individuals and businesses voluntarily paying the taxes they owe. To the extent that this system works, it

improves the efficiency of tax collection. Measuring the extent to which the tax system works and identifying areas in which it does not is the job of compliance measurement. TCMP has been IRS' only tool for measuring voluntary compliance and determining compliance issues. The postponed TCMP for 1994 tax returns was to establish the voluntary compliance benchmark to carry IRS into the next century.

Results in Brief

According to IRS officials, criticisms of TCMP and budget difficulties make it unlikely that the 1994 TCMP, as planned, will be conducted. Although IRS officials told us that data on taxpayer compliance with tax laws are still needed, and they plan to obtain them; they currently do not know how they will get them. They said the loss of 1994 TCMP compliance data could lead to an increased burden on compliant taxpayers over the long term, if return selection formulas become less efficient and increasing numbers of compliant taxpayers are selected for IRS' regular audit program.

In addition to measuring voluntary compliance, the 1994 TCMP was to provide compliance data for several IRS initiatives, including updating return selection formulas, validating the market segment approach, and providing data for compliance research. The absence of this type of compliance data will make it more difficult to accomplish the objectives of these initiatives.

To mitigate the difficulties this absence of updated compliance data may cause in the short term, IRS would have to identify and implement an alternative method of obtaining the data. To build on the significant resource investment already made and to conserve time, this effort would benefit from using data already collected for the 1994 TCMP.

Currently, while IRS plans to mitigate the data losses resulting from the postponement of the 1994 TCMP, it has no specific proposal on how to accomplish this. However, on the basis of our discussions with IRS staff and our experiences with past TCMPs, we identified some possible short-term sampling alternatives for IRS' consideration. It appears that IRS could reduce the burden and costs of TCMP by changing the design parameters to accept a smaller sample of tax returns to audit, thus achieving at least some of the benefits that the postponed TCMP study was designed to achieve. Although there are numerous sampling strategies that could be used, some alternative design parameters could include reducing the types of tax returns covered, changing the precision of the sample results by reducing the number of returns audited, and excluding the

returns of taxpayers who appear to IRS auditors to be compliant. We estimate that these changes could reduce the sample size by up to 119,000 of the 153,000 returns. None of these sampling strategies would provide the quantity or quality of data that were to be provided by the planned TCMP, such as the ability to provide estimates of noncompliance at the field office level. However, they could, at a minimum, provide national compliance information and, potentially, data to update at least some of IRS' audit selection formulas.

Because a significant portion of IRS' workload and future revenue collections depends on compliance programs, IRS will need to determine how it will measure compliance over the longer term. Such measurements are an ongoing need for any tax system that depends on voluntary compliance. The compliance measurement program's sustainability, in view of budget limitations and taxpayer burden concerns, is a key planning consideration for any long-term program. IRS officials said that potentially long-term alternatives may include, (1) conducting multiyear TCMP type audits from smaller samples of tax returns and combining the data from several years to ensure the necessary precision and coverage; (2) using data from operational audits to assess changes in compliance; and (3) conducting a national "mini" TCMP type audit periodically to identify emerging issues, followed by smaller audit efforts on the issues identified in this national effort. Each of these alternatives would be cheaper and less burdensome to IRS and taxpayers than the proposed TCMP sample but would also provide less comprehensive compliance data.

Regardless of how IRS decides to replace the information that would have been provided by TCMP, it is important to begin soon because any alternative is likely to require several years to put into place, and the data will be needed to update information on IRS' compliance programs. For example, if data from a short-term alternative were available by 1998, the year IRS originally estimated the completed data would be needed, it would cause the least disruption to IRS' compliance program.

Objectives, Scope, and Methodology

The objectives of this assignment were to (1) determine the possible effects on IRS' compliance programs of postponing the 1994 TCMP and (2) identify some potential short- and long-term alternatives to the planned TCMP for collecting this data.

To determine the possible effects of postponing the 1994 TCMP, we talked to responsible officials in IRS' Research Division and the Examination

Division. We obtained information on how these officials planned to use TCMP data and what will likely be affected now that TCMP has been postponed.

To identify alternatives to the planned TCMP, we talked to IRS officials responsible for planning TCMP. We discussed alternative sampling methodologies with officials from IRS' Statistics of Income (SOI) Branch who were responsible for preparing the original TCMP sample and asked them to determine sample sizes on the basis of revised requirements. We developed the revised requirements on the basis of our discussions with IRS' Research Division staff as well as officials outside IRS, including congressional staff.

Some of the observations in this report are based on the work we have done over the years on IRS' compliance programs as well as our specific work on TCMP in recent years.

We requested comments from you on a draft of this report. On February 23, 1996, we obtained oral comments from IRS' Director of Research and the National Director of Compliance Specialization. We also obtained comments from you in a March 18, 1996, letter. These comments are discussed on page 13 of this report.

We did our work in San Francisco, Dallas, and Washington, D.C., between August and December 1995 in accordance with generally accepted government auditing standards.

Loss of TCMP Data Could Disrupt IRS' Compliance Strategies

The planned TCMP for 1994 tax returns was to establish the voluntary compliance benchmark to carry IRS into the next century. While agency officials said that postponing TCMP will help resolve budget problems, our work suggests that the loss of these or comparable data is also likely to disrupt IRS' efforts to increase the total collection percentage to 90 percent by 2001. For example, without these data, IRS will have difficulty updating the formulas it uses to select returns for audit and, thus, it would be more likely that a higher percentage of the returns IRS selects for audit would not result in changes to the amount of tax owed by the taxpayer. Additionally, without such data IRS will be unlikely to have sufficient data to validate its market segment approach to audits or to be used by the DORA research functions to identify programs to improve voluntary compliance. It is not clear whether IRS will replace the data it had planned to obtain from TCMP. However, updated compliance data will be needed in

the short term if IRS still plans to update the audit selection formulas and in the long term to validate and improve IRS' compliance efforts.

Updated Compliance Data Were Needed to Update Return Selection Formulas

The primary system that will be disrupted by postponing TCMP is the one used by IRS to select returns for audit. Since 1969, IRS has used DIF formulas to select returns for audit. New DIF formulas are developed periodically from TCMP data and applied to all individual and small corporation income tax returns. IRS then selects returns for audit with the highest DIF scores. In 1992, over 55 percent of the audited returns of individuals were selected using the DIF score.³ The DIF selection system replaced programs that were largely dependent on auditor's judgment. The DIF system has not only improved the efficiency of IRS' audit efforts but also the consistency and objectivity of the selection process. The use of the DIF selection process has also resulted in fewer "no-change" audits,⁴ which not only waste IRS' resources but unnecessarily burden compliant taxpayers. According to IRS, use of the DIF scoring system reduced the no-change rate from over 46 percent in 1969 to about 15 percent in 1992.

IRS officials believe the DIF process is dependent on periodically updating the formulas used to score returns. Formulas are updated so that they will more accurately identify the returns with the greatest probability for change. Until 1988, data from TCMP had been used to update formulas for individual returns every 3 years. However, the most recent TCMP was conducted on 1988 individual returns. For small corporations, partnerships, and S corporations, IRS has updated formulas much less frequently. TCMPs were conducted on corporate returns filed in 1987, and partnership and S corporation returns filed in 1982 and 1985, respectively.

IRS is not certain how well the DIF scores will continue to perform if not updated. IRS officials believe that by 1998, the year IRS planned to have TCMP data available, the DIF scores may become less effective at identifying returns with the greatest potential for change. They said this decrease in effectiveness may occur because of changes in tax laws and taxpayer behavior—resulting in an increased no-change rate for DIF selected returns and potentially lower revenue yields. This would mean greater burden on

³In 1993 and 1994, a smaller proportion of the examined returns were selected using DIF because of a 2-year special nonfiler compliance initiative conducted by IRS' Examination Division. IRS officials expect the proportion of returns selected using DIF to again increase as this nonfiler initiative is completed.

⁴"No-change" audits are those that did not change the reported tax liability.

compliant taxpayers if more of them are selected for audit. IRS officials indicated that they plan to monitor the performance of DIF over time.

Compliance Data Needed to Validate Market Segment Approach

The 1994 TCMP was also intended to provide information on IRS' new market segment approach for grouping tax returns. IRS initiated the market segment approach on the basis of work done in its Western Region, which indicated that compliance rates and audit issues were likely to be similar for taxpayers with similar characteristics, such as businesses in the same industry (e.g., manufacturing or retail sales). Accordingly, IRS concluded that grouping taxpayers by market segments might result in selecting returns for audit that have a higher potential for change and might allow auditors to specialize in market segments.

The 1994 TCMP was designed to provide data to test this hypothesis as well as to develop DIF scores by market segment rather than by audit class, as had been done in the past.⁵ Without TCMP or some alternative to provide similar information, IRS will not have data to show whether market segments are better for return selection purposes than traditional audit classes or be able to determine the compliance rate or compliance issues of the market segments. Because of these concerns, IRS no longer plans to test a selection of returns for audit by using the market segment approach. Instead, IRS plans to continue selecting returns for audit using the DIF score within audit classes.

TCMP Was Designed to Support IRS' Research Function

Finally, the 1994 TCMP was designed to provide compliance data for IRS' National and District Research Offices. IRS established these offices to research taxpayer compliance at the national and local levels. These researchers were to identify programs to improve compliance not only through audits but also through larger scale nonaudit programs, such as improved guidance and assistance to taxpayers and tax-law changes. TCMP also was to be used to develop benchmark compliance data for measuring future progress and determine how effectively managers were meeting their objectives of improving compliance.

Without TCMP or an alternative data source, IRS' new research function would still be able to analyze noncompliance in filing returns and paying taxes. However, research on reporting compliance, the area where most of IRS' compliance dollars are spent, would be very limited. Thus, researchers

⁵IRS developed DIF formulas for each of 10 audit classes. These audit classes separate taxpayers on the basis of the amount of income and type of return filed.

would have inadequate data to identify emerging trends in reporting compliance, to develop solutions, and to test the effectiveness of these solutions. As a result, IRS would likely continue its reliance on enforcement to improve compliance. However, enforcement has proven to be a costly and ineffective way to increase overall voluntary compliance.

Possible Short-Term Approaches to Collect Compliance Data

According to IRS officials, because of criticisms of TCMP and budget concerns, the 1994 TCMP is unlikely to be conducted. Although IRS officials told us they planned to use an alternative method to obtain TCMP data, they currently have no short-term proposal on how to obtain these data. Regardless of how IRS plans to mitigate the loss of 1994 TCMP data, it would have to start soon in order to minimize the adverse effects of not updating its compliance programs.

According to IRS officials, a number of alternative sampling strategies could fill the short-term data gap created by postponing TCMP indefinitely. From these strategies, we identified several alternative samples that met three basic objectives we considered important: (1) reducing the sample size to make data collection less costly for IRS and less burdensome to taxpayers, (2) maintaining IRS' ability to update the DIF scoring system, and (3) maximizing use of the work already completed to identify returns and collect data for the 1994 TCMP sample.

One alternative sample would be for IRS to reduce the planned TCMP sample size and still provide some of the same data, although with less precision. This smaller sample could also be used to update the DIF score with little loss in accuracy.⁶ On the basis of our discussions with SOI officials, it appears IRS could reduce the sample size in any one of several ways, including

- decreasing the level of acceptable statistical precision for individual and corporate returns;⁷

⁶The primary criteria for updating the DIF score is the profitable-to-audit requirement. Each individual and small corporation strata must have at least 500 such returns. The profitable-to-examine level (i.e., amount of adjustments) ranges from \$500 for certain nonbusiness individuals to \$10,000 for some sole proprietors and corporations. The most recent TCMP is used to estimate the number of profitable-to-audit returns within a strata.

⁷IRS uses the coefficient of variation (CV) ratio as a measure of the sample's precision. The CV is the ratio between the standard error of the mean divided by the mean. The CV ratio measures the precision of sample point estimates and is calculated using data from prior TCMPs. A sample with a CV ratio of 1 is generally twice as reliable as a sample with a CV ratio of 2. For our alternative samples, we asked IRS to increase the CV ratios as follows: Individual nonbusiness returns to 5 percent, individual business returns to 2 percent, corporation returns to 5 percent. The CV ratios were changed from 3.5 percent, 1 percent, and 2 percent, respectively.

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- selecting a sample with only businesses (sole proprietors, corporations, partnerships, and S corporations), with reduced precision;
 - classifying TCMP sample returns and eliminating returns that past audit experience indicates are not likely to result in an audit adjustment;⁸ and
 - selecting a sample that includes only sole proprietor and corporation returns.

Numerous other alternatives to the sampling methodology and characteristics may give slightly different sample sizes. For example, by eliminating the requirement for updating the DIF formula, the sample size for the corporation and individual business option is reduced by about 12 percent, to 28,275. However, such an approach would lessen the value of TCMP because it would limit IRS' ability to update the DIF score, a primary purpose of TCMP audits.

Reducing the sample size would reduce the cost of TCMP audits. IRS' cost estimates for the 1994 TCMP were divided into two types, (1) staffing costs and (2) opportunity costs. Staffing costs reflect IRS' cost estimates for auditors to conduct the TCMP audits. Opportunity costs reflect IRS' estimates of the difference between revenue generated through the regular audit program and revenue generated by TCMP audits. According to IRS officials, TCMP audits generate less revenue because the returns are randomly selected rather than identified by using the DIF score or as part of a special project and because the returns take longer to audit.

Table 1 shows how the variations in sampling methodology and characteristics change the sample size and cost estimates.

⁸Included in this sample is a 2 percent subsample of the no-change returns to validate the classification.

Table 1: Changes to Sample Size and Cost Estimates Based on Changes to Sampling Characteristics

Dollars in millions

Sample characteristics	Sample size by return type ^a				Total	Cost estimates	
	1040	1120	1120S	1065		Direct	Opportunity
Original sample	92,185	35,360	12,501	12,488	152,534	\$558	\$1,452
Decrease the precision of the sample	52,313	15,121	12,501 ^b	12,488 ^b	92,423	309	805
Sample businesses only	18,267	15,121	12,501 ^b	12,488 ^b	58,377	280	727
Classify returns and delete no-change audits	36,909	8,063	6,666	6,659	58,297	184	479
Sample corporations and sole proprietors only	18,267	15,121	0	0	33,388	153	397

^aThe following return types were to be included in TCMP: Form 1040 Individual Income Tax Return, Form 1120 Corporation Income Tax Return, Form 1120S S Corporation Return, and Form 1065 Partnership Income Tax Return.

^bSample size for partnership and S corporation returns remains the same as in the original 1994 TCMP sample for all options for which these types of returns are included, because IRS has no data on which to determine the number of returns that would be profitable to examine.

Source: Sample size data provided by IRS' SOI staff and cost estimates calculated by GAO based on IRS' cost information for the planned 1994 TCMP.

Changing the sample characteristics not only reduces the size but affects the usefulness of data from the sample. Each of the changes shown in table 1 has its own set of strengths and weaknesses that relate primarily to reliability and coverage. For example, reducing the sample to businesses only and reducing the precision would provide no information on nonbusiness individuals. Also, this sample would be of little use at the DORA level because it would not provide statistically reliable estimates of compliance below the national level. This sample could, however, provide some information on market segment compliance and be used to update the DIF formula for businesses and the return types where voluntary compliance is the lowest. Also, a business-only approach could be combined with a multiyear sample where the compliance of nonbusiness individual returns is evaluated in a future year. Although we did not fully evaluate the alternatives, the table in appendix I summarizes some of the more obvious trade-offs inherent in the alternatives discussed above.

Deciding how to change the sampling strategy to reduce the sample size would require careful evaluation of the tradeoffs. It seems reasonable, however, to consider that any new sample should, at a minimum, allow some updating of the DIF formulas, since this was to be the primary purpose of the original TCMP. To the extent that other purposes can also be

met through one of these alternative sampling strategies, the sample would be more valuable.

Long-Term Compliance Measurement Considerations

Because a significant portion of IRS' workload and future revenue depends on compliance programs, it is important that IRS determine how to measure compliance. Such measurements are an on-going need for any tax system that depends on voluntary compliance. It is also important that any long-term solution to obtaining compliance measurement information address the issue of sustainability so that long-term consistent measurement data are available. Sustainability means that the program's costs, in terms of IRS' budget and perceived burden on the taxpayer, must be clearly defensible. Additionally, to be efficient and effective, it would be necessary to design a program that provides timely data and clearly identifies the objectives and uses of these compliance data.

We identified several alternatives to the traditional TCMP that would meet some of the data needs that were lost when TCMP was postponed, including (1) conducting multiyear TCMP audits on smaller samples and combining the results; (2) using operational audit data; and (3) conducting a mini TCMP to identify compliance issues, with a more focused TCMP audit on the identified issues. We discuss these three options below.

Using Multiyear TCMP Audits

The multiyear TCMP alternative envisions annual TCMP-type audits on a smaller sample of tax returns which, over the course of several years, could be combined to obtain the required statistical precision. For example, IRS could disaggregate an entity type, such as individual taxpayers, into separate market segments or audit classes and conduct the audits of each segment on a 3-year cycle. Table 2 below shows an example of how such a program might operate.

Table 2: Example of a Multiyear TCMP Effort

Year	Type of return audited	Number of returns
1	Individual, nonbusiness, total positive income less than \$50,000	16,363
2	Individual, nonbusiness, total positive income \$50,000 or more	14,508
3	Individual, business or farm	18,267
Total		49,138

Source: Estimates made from data provided by IRS for our alternative sampling strategies.

One benefit of such an approach to IRS would be that after the initial 3-year period, new and current data would become available for one of the segments every year, making it easier to fine-tune the compliance system. Such an approach, however, would require considerable effort from IRS' statisticians to ensure that the sample design was statistically sound. Also, it would require a long-term commitment from IRS managers to ensure that returns were audited regularly.

Using Operational Audit Data

A second option is to use data from operational audits already being done. Using data from operational audits would provide a large amount of compliance data. This option is also probably the most sustainable of the three we discuss because it would be less burdensome on compliant taxpayers and have no marginal staffing and opportunity costs. However, there are weaknesses. IRS currently has no system to track operational audit issues. While such a system is currently being developed, it is not yet operational and testing is not planned to begin until later in 1996. According to IRS officials, this database is to identify audit issues as well as provide codes to identify the causes of noncompliance. Also, IRS officials believe that using a database of operational audit results could not be used for updating the DIF formulas, determining ways to improve voluntary compliance, or systematically identifying emerging audit issues because the audited returns would not be randomly selected.

Using a Mini TCMP

A third option is to periodically conduct a very small TCMP that covers all taxpayers and follow up with mini TCMP audits on specific issues identified as concerns. Using this approach, IRS may be able to reduce the sample size and focus the majority of the audits on less compliant taxpayers, thus reducing cost and taxpayer burden. This approach may also provide IRS with insight into the areas of greatest noncompliance because efforts would be more focused. IRS officials said that this approach, however, would probably not provide sufficient data to update the DIF formulas and may be of little use at DORA sites because too few randomly selected returns would likely be examined.

Conclusions

A significant proportion of IRS' present and future compliance programs have been predicated on the information obtained from TCMP. Benchmarking current compliance, validating the market segment approach, updating return selection formulas, researching noncompliance issues and developing programs to address them, and estimating the tax

gap all depend on TCMP information. Without updated compliance data, increasing voluntary compliance, as envisioned by IRS, is less likely to occur.

IRS has options to replace at least some of the data that would have been available from the 1994 TCMP audits. Auditing a smaller sample size by eliminating some return types and accepting a decrease in precision, is a factor in such options. While each of these alternatives has limitations, they would meet some of the data needs that were lost when TCMP was postponed. It is important for IRS to make a decision soon on how to replace TCMP data because it will take some time to implement a replacement, and IRS projects that the currently available 1988 data will be less effective by 1998.

If IRS does not develop a sustainable compliance measurement program, IRS' compliance programs may be disrupted as the proportion of audits that result in no-changes increases and IRS' access to information on emerging compliance issues decreases. In the long term, such disruptions are likely to result in increased burdens on compliant taxpayers as more of them are selected for audit.

Recommendations

To provide the data necessary to help meet the objectives of IRS' compliance strategies, we recommend that you

- identify a short-term alternative strategy to minimize the negative effects of the compliance information that is likely to be lost because TCMP was postponed, and
- develop a cost-effective, long-term strategy to ensure the continued availability of reliable compliance data.

Agency Comments and Our Evaluation

We requested comments from you on a draft of this report. Responsible IRS officials, including the National Director, Compliance, Research and National Director, Compliance Specialization, provided comments in a February 23, 1996, meeting. These officials agreed with our recommendations and provided some technical comments, which we have incorporated where appropriate. In a March 18, 1996, letter, you restated those agreement and indicated that over the next several months IRS would devote substantial effort to investigating all potential options for capturing reliable compliance information as an alternative to TCMP.

We believe the actions that IRS proposes, if properly implemented, will be responsive to our recommendations.

This report contains recommendations to you. The head of a federal agency is required by 31 U.S.C. 720 to submit a written statement on actions taken on these recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Reform and Oversight not later than 60 days after the date of this letter. A written statement also must be sent to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of this letter.

We are sending copies of this report to pertinent congressional committees with responsibilities related to IRS, the Secretary of the Treasury, and other interested parties. Copies will be made available to others upon request.

The major contributors to this report are listed in appendix II. If you have any questions, please contact me on (202) 512-9044.

Sincerely yours,

A handwritten signature in black ink, appearing to read 'Natwar Gandhi', with a large, sweeping flourish extending to the left.

Natwar Gandhi
Associate Director, Tax Policy
and Administration Issues

Trade-Offs With Alternative Sampling Strategies

Sample characteristics	Trade-offs of adjusted sample	
	Positive	Losses
Original sample	Useable to update DIF scores, provides baseline compliance for market segments, useable at the DORA level for most market segments, very precise compared with other options.	Large sample size requiring significant resource and cost commitment.
Decrease the precision of the sample	Useable to update DIF scores, provides baseline data for national market segments, reduces the sample size and burden.	Not useable at the DORA level.
Sample business returns only	Useable to update DIF formula for businesses, where the most noncompliance occurs, provides baseline data for national market segments, reduces the sample size and burden.	Not usable to update the DIF score for individual returns, not useable at the DORA level.
Classify returns and exclude those that appear to be no-change returns	Possibly useable to update DIF formulas, would provide some national market segment information, reduces the sample size and burden.	Not useable at the DORA level, problems identifying no-change returns.
Sample corporations and individual businesses only	Useable to update DIF formulas for selected classes of business return, provides national market segment compliance data, reduces the burden on individual taxpayers.	Not useable to update the DIF score or identify compliance issues for nonbusiness individuals, partnerships, and S corporations not useable at the DORA level.

Source: Based on prior TCMP work and discussions with IRS staff.

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